A PAINFUL TRANSITION

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Dear Reader

Given that most decision-makers tend to shy away from actions likely to shock, normalizing fiscal or monetary policy after years of excesses usually takes time. Nevertheless, markets are currently experiencing a form of cold turkey, shivers, and fever, as most stimulus has gone into reverse. Since this is not only the case in the developed world (which is trying to wean itself off a decade or more of easy money and the fiscal splurge of the pandemic era), but also in many emerging markets (most prominently, of course, China), the repercussions are being felt everywhere and will continue to be felt.

For investors, this has meant another challenging quarter with surging yields, falling stock prices, and wild gyrations in currency and commodity markets. Near-term, much of the same is to be expected. Nevertheless, there are signs of a silver lining in the form of interest rates which have now reached decidedly attractive levels. It's time for us to call on investors to stop sitting on the fence and start looking at options to lock in yields for longer. We have summarized our arguments for building up quality bond exposure in this issue's Special Topic.

Market visibility remains unusually poor. In such circumstances, nothing beats a good conversation with a trusted counterpart to check and challenge one's views and convictions. Please don't hesitate to reach out to us! We look forward to continuing our robust dialog.

Yours sincerely

Dr. David Wartenweiler
Chief Investment Officer

THE MACRO BACKDROP
Cyclical vs. structural challenges

As the year has progressed, growth trends have increasingly diverged across the globe. At this point the US stands out with its resilient economy, despite the highest Fed rates since the early 2000s. Europe is teetering on the brink of a new downturn, while China is increasingly eclipsed by India, the new Asian powerhouse.

Key points

- US growth set to slow materially in the quarters ahead
- Stagflation a realistic scenario for Europe
- India set to challenge China as a driver of global growth

US: resilience set to be tested

Strong consumer demand and generous government spending have kept the US cycle alive against all odds. Eventually, though, this cycle too will mature as higher rates and tighter credit conditions start to take their toll. Since inflation has remained stubbornly above target, the Fed has little choice but to stay firm. Depending on how higher energy prices impact upcoming inflation data, some additional tightening remains conceivable. In fact, although the Fed no longer expects activity to contract, it is hoping for a period of sub-trend growth to rebalance the economy. A looser labor market should then calm wage growth, which has been running well ahead of trend and has been one of the main factors sustaining growth this year. The other major factor has been increased government spending and subsidies reinvigorating business investment, which looked poised to weaken earlier in the year. It is doubtful whether spending, let alone spending growth, will be maintained at this level, creating additional downside risks. The advent of a presidential election campaign and rising funding costs are likely to impact this dynamic negatively. While the market has adopted the narrative of a soft landing, a more pronounced downturn cannot be ruled out.

Europe: facing stagflation

The scenario most feared by governments and central banks alike threatens to materialize in Europe: low or even negative growth and inflation well above target. Although most major European central banks may be close to the end of their tightening cycle or already have reached it, high inflation will not allow for much cutting. This means that monetary policy will not be able to come to the rescue of a continent struggling with weak external demand and structural disruptions to its industrial base as a result of the war in Ukraine.

China: not out of the woods

The deleveraging of China's property sector continues to run its course – painfully so, as is usually the case when real estate bubbles deflate. As a result, Chinese growth will remain depressed for a considerable time, especially since the increasingly ideological government is unwilling to take more proactive measures to limit the fallout. While China will not implode, the country risks being overtaken by India as the main contributor to global growth within less than a decade.

Table 1: Real GDP growth (y/y in %)

	2022E	2023F	2024F	Short-term trend
United States	2.0	0.5	2.2	↘
Eurozone	0.5	0.8	1.5	→
Germany	-0.3	0.6	1.5	→
United Kingdom	0.4	0.5	1.5	→
Japan	1.8	1.0	1.0	↘
China	5.1	4.5	4.5	→
India	6.1	6.3	6.3	→
Russia	1.7	1.2	1.0	↘
Brazil	3.0	1.5	2.0	→

Table 2: Consumer price inflation (y/y in %)

	2022E	2023F	2024F	Short-term trend
United States	4.1	2.6	2.3	↘
Eurozone	5.6	2.7	2.1	↘
Germany	6.1	2.9	2.1	↘
United Kingdom	7.5	3.1	2.1	↘
Japan	3.1	1.9	1.4	↘
China	0.6	1.9	2.0	↘
India	5.4	4.6	4.6	→
Russia	5.6	5.2	4.1	↗
Brazil	4.7	4.0	3.7	↗

Source: Bloomberg, HBZ

INVESTMENT STRATEGY

A painful transition

Equities are expensive and bonds are cheap. If only it were so simple! Investors currently face a very complex set of circumstances in which most options look second best. We recommend focusing on long-term investment objectives and accepting the inherently fickle nature of financial markets.

Key points

- Yields favor fixed income over equities
- EM assets have lost their luster
- Soft landing or not – that is the question

Looking for a turning point

The current investment cycle has reached a state where most assets have lost their luster. Equities are either expensive, as is the case for the US market, or damaged goods, the case for European and emerging market (EM) shares, which, while attractively valued, are trading at a discount owing to structural growth concerns. Bonds look cheap, but with every passing day they become cheaper as yields continue to rise. Cash appears to be the only valid option, as is often the case when markets approach a cyclical downturn. But cash is also the financial market's equivalent of a procrastinator, who unable to decide sits on the fence and then misses opportunities. For investors with a longer investment horizon, weak market conditions such as those currently prevailing are a chance to build positions over time. As is evident from straightforward statistical data, time in the market ultimately matters much more for success in investing than the ability to time markets – something that eludes even many of the top market professionals. In times like these, investors should focus on their long-term goal and accumulate the types of assets they need to meet their objectives. From that perspective, high-quality fixed-income assets look the most attractive. Yields are at levels not seen in years and duration risk will translate into capital gains once the cycle has turned for good.

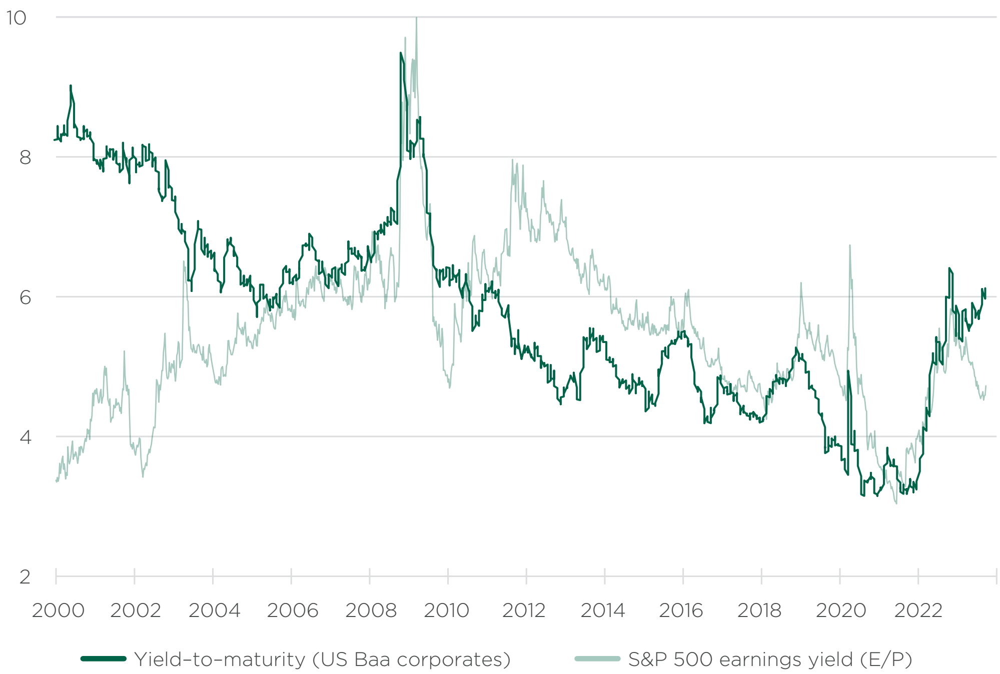
Our positioning

The current market environment continues to demand a defensive positioning in equities, which we have accentuated over the past quarter by reducing exposure to Europe and EM in favor of the US. Similarly, we have reduced exposure to EM fixed income, as this asset class no longer offers as compelling risk-adjusted returns as high-grade corporate bonds. Finally, we maintain alternative assets owing to their diversifying properties and more asymmetrical return profiles.

What to watch

The prevailing macro narrative is one of a soft landing of the US economy with limited disruption to markets. We have our doubts about this scenario and will be watching for data confirming or refuting this hypothesis. In this context, corporate earnings will be of paramount importance. Another quarter of negative earnings growth could further undermine investor confidence.

Favor corporate bonds over stocks



Source: Bloomberg, HBZ

FIXED INCOME

Time to lengthen duration

During the past quarter, bond yields have surged again across the board. We have now reached the point where taking some additional duration risk makes sense for investment-grade issuers. On the other hand, we are bearish on high yield. In EM we prefer more defensive quality bonds.

Key points

- Time to lock in yields of quality bonds
- Corporate hybrids as attractive satellites
- Stay defensive in EM

A portfolio of quality bonds

Bond yields have surged once more during the past quarter, and some further upside remains possible. Over the medium term, however, yields should settle again at lower levels, making this a good entry point to add investment-grade bonds. They offer the opportunity to lock in the highest yields in years and, at current levels, quality investment-grade bonds represent the best risk/return. There is no need to go further down the rating scale. Spreads on high-yield bonds, which have performed remarkably well this year so far, are too tight, and considering the cyclical backdrop and increasing refinancing needs are not attractive.

Corporate hybrids as a satellite

Currently, corporate hybrid bonds look attractive on a risk-adjusted basis compared with the corresponding senior debt. Corporate hybrids are subordinated bonds issued by non-financial companies (mainly utilities and telcos) with an investment-grade rating at the time of issue. Hybrids are usually perpetuals or at least have a long final maturity. Owing to the inherent risk that embedded calls may not be exercised, this segment is best accessed through actively managed collective investment vehicles.

EM divergence amid uncertainty

A decelerating global economy, coupled with lower Chinese demand and elevated US interest rates, has created an unfavorable environment for emerging market (EM) bonds. Nevertheless, the impact of the "higher for longer" scenario is not uniform across EM credit, rates, and foreign exchange markets. Countries likely to fare better are commodity exporters and those that have minimal external financing requirements, such as the members of the Gulf Cooperation Council (GCC). Conversely, frontier markets with high external debt and managed exchange rates, for example Pakistan and Kenya, are poised to face more challenges. Some low-rated countries may still want to tap primary markets, but prohibitively high spreads could restrict their access and push them into financial distress. As a result, we expect continued pressure on the higher-yielding EM segment. On the other hand, investment-grade sovereign issuers and better-rated high-yielders should exhibit greater stability thanks to their lower external debt and greater reliance on commodity exports. For the time being, we continue to favor this more defensive segment of the market.

US corporate bond yields back to pre-2008 levels

Bloomberg, HBZ

EQUITIES

When the tide shifts, quality prevails

Global equities performed strongly until August. Then, as longer-dated yields kept rising alongside oil prices, the market narrative changed, triggering a correction. While trading conditions will remain challenging, reasonably priced stocks with both quality and low volatility features should outperform in the final quarter.

Key points

- Change of market narrative reverses market sentiment in August
- High yields and oil prices main drivers of sell-off
- Favor quality stocks to shore up portfolios

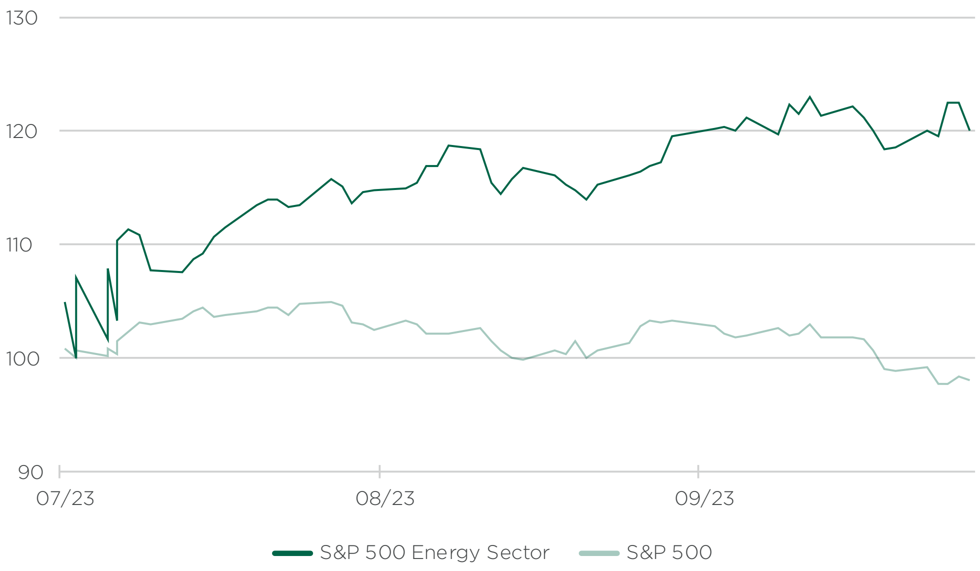
Good news is bad news

Global equities rallied until August, as the US economy proved to be exceptionally resilient. US consumers were able to keep spending thanks to higher wages, courtesy of robust labor markets, plus the fact that they were able to tap into their savings. As a result, corporate earnings surprised to the upside, confounding analysts who had lowered their forecasts on the widely-held belief that the US economy would move into recession in late 2023. In response, investor positioning became very bullish at the end of July, but some profit-taking followed soon after. Suddenly, the market narrative changed to "good news is bad news," as positive economic news also meant interest rates would stay higher for longer. Towards the end of the quarter, longer-term yields in the US and Europe soared, causing the yield curve to steepen. Consistent with this narrative, both equities and bonds declined, leading to a sharp increase in equity and bond correlation, which in turn reduced the diversification benefits for a typical multi-asset portfolio. To make matters worse, OPEC+ extended its production cuts, pushing up oil prices and putting renewed upward pressure on headline inflation, which will delay any potential rate cuts for even longer.

Quality set to hold up best

While long-term inflation expectations remain well anchored, the combination of higher US real yields and higher oil prices has triggered a sell-off of risky assets, especially long-duration assets which have their cash flows far out in the future, e.g., stocks trading on the NASDAQ. More generally, growth stocks underperformed value stocks and large-cap stocks outperformed smaller ones, suggesting a near-term slowing in economic activity. On the other hand, in the third quarter investors favored defensive equities offering strong balance sheets (quality) and low volatility. Energy, an industry typically associated with lower valuations, strong balance sheets, and high dividends, stands out as the best-performing sector. Looking ahead into the fourth quarter, we expect this trend to continue, with high-quality and low-volatility stocks at reasonable valuations set to outperform on a relative basis in a context of elevated interest rates and slowing growth. Regionally, fundamentals will continue to favor the US, greatly diminishing the valuation advantage of Europe and emerging markets.

Energy sector surges in down market



Source: Bloomberg, HBZ

COMMODITIES AND FX

It's still a dollar world

The Fed's mantra of "higher interest rates for longer" is providing a lifeline to the US dollar, which has strengthened against most currencies during the past quarter. At the same time, tight supply in the crude market has pushed oil prices higher, while gold remains in high demand despite rising real rates.

Key points

- Oil demand increasing faster than supply
- US dollar supported by high interest rates and robust economy
- Real rates weigh on gold

No peak oil yet

Despite all the talk about renewable energy, oil demand continues to grow, currently faster than supply, leading to lower inventories and higher prices. The main factor behind the latest price surge for crude is the OPEC+ decision to limit its output. Saudi Arabia for one is targeting a price above USD 80–90/bbl to be able to balance its budget, and Russia needs revenue from oil exports to fund its war against Ukraine. Meanwhile, US oil stocks have fallen to their lowest level in 40 years owing to years of underinvestment. The oil market will eventually feel the headwinds from higher interest rates and slower growth in China, but until then crude will remain well bid.

A lifeline for the USD

Market expectations that the Fed will maintain a high level of interest rates for an extended time have lifted the USD after a period of weakness. The currency's rebound has also been driven by the US economy's stronger-than-expected growth, while the probability of a severe recession has diminished. Historically, the US dollar tends to weaken when global growth is recovering, which is definitely not the case at the moment. Quite to the contrary: China's economy is mired in the fall-out of the real estate meltdown with limited scope for major policy stimulus, while Germany, the eurozone's largest economy, is de facto in recession. This means there are currently few viable alternatives to the US dollar, since most major currencies are exhibiting fundamental weaknesses that are unlikely to dissipate in the near term. That said, the dollar is overvalued by most metrics from a long-term perspective; but at this stage we prefer to be overweight for the months ahead. What could change our view? First, as mentioned already, global growth would need to bottom out and secondly, the Fed's tightening cycle would need to come to an end, creating the conditions for lower USD interest rates in the medium term.

Gold challenged by real rates

For gold, real rates, i.e., interest rates adjusted for inflation, are a key driver. At their current elevated levels, real rates are unfavorable. While this creates some additional price risks, we remain structurally bullish thanks to the demand from central banks and the metal's property as a hedge against future USD weakness.

Crude oil surging on tight supply

Source: Bloomberg, HBZ

KEY MARKETS
Catching a breather

Following a period of challenges on both the global and domestic fronts, our key markets are showing scattered signs of relief, with Pakistan adopting some economic discipline, the UAE supported by a resurgence of oil prices, and the UK seeing inflation roll over.

Key points
- Pakistan committed to painful economic discipline
- Oil rally shores up UAE economy
- BoE pauses rates after fourteen consecutive increases

Pakistan: caretakers at the helm

The government term ended with the last-minute renewal of the IMF agreement and some policies to abate Pakistan's economic woes. Then the caretakers took over. Avoiding populist measures and following the IMF program, the interim government appears determined to follow the path to economic stability. The moves have led to public protests over the impact of surging costs of living resulting from hikes in electricity tariffs, fuel prices, and the imminent prospect of major gas tariff increases. On a different front, progress has been made to curtail speculation on the PKR, which gained 6% after collapsing to PKR 307 against the USD – an all-time high. Inflation slowed to a still whopping 27% in August from over 28% in July, leading the State Bank to leave the policy rate unchanged at 22% in September. The political uncertainty eased as, after much delay, election dates were announced for the end of January next year. The economy has had a breather after the country reported a current account surplus four months running before returning to a deficit in July, and the outlook for agriculture has improved thanks to growth in cotton production and similar expectations for winter crops.

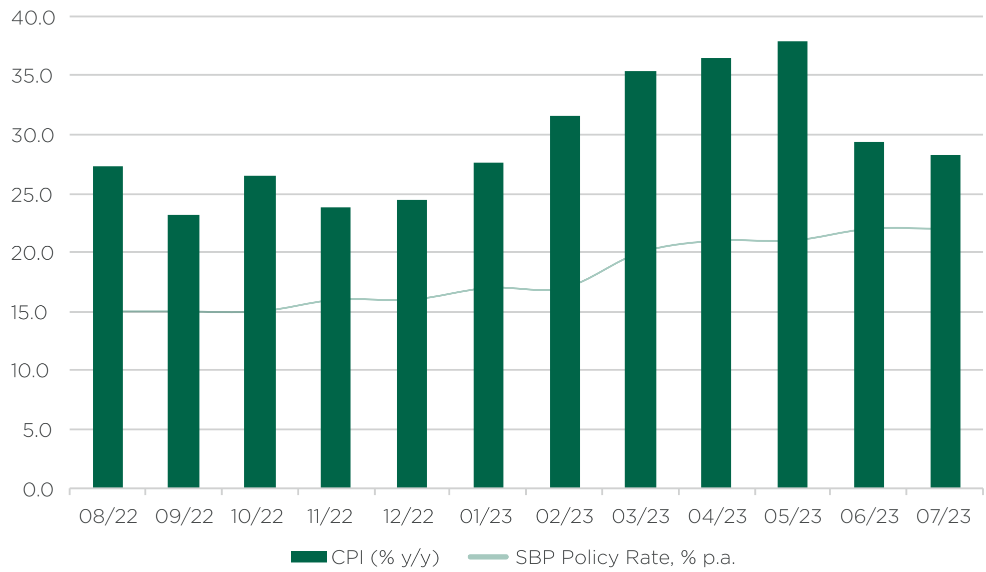
UAE: on the right side of oil

While the numbers for 1Q23 marked a slowdown in growth to 3.8%, the UAE remains well-supported on the back of tourism and the renewed rally of oil prices. OPEC's voluntary output cuts have led to a tight oil market as consumption has outpaced production. Oil prices reached their highest level for the year, with Brent trading at around USD 95/bbl as inventories were depleted further in August. This has helped the oil-based economy through a slow start to the year. At the same time, tourism is driving the non-oil sector, with the number of visitors expected to grow by about 40% this year.

UK: glimpses of relief

After a period of firefighting and fourteen interest rate hikes in a row, the Bank of England (BoE) paused its tightening cycle at its September meeting. Multiple data points swayed a majority to remain on hold, including a dip in inflation to 6.7%, a pullback of the PMI into contractionary territory, and indications of an easing labor market. In turn, the GBP has lost much of its strength since the beginning of the year, declining more than 6% from its peak against the USD in July.

Pakistan: inflation still above record-high policy rates



Source: Bloomberg, HBZ

SPECIAL TOPIC

Money market is for the short term

The surge in interest rates has seen investors flock back into the long-deserted money market space. Virtually no interest rate risk and limited credit risk make these assets a perfect safe haven. Their current attractiveness may not last, however. Investors need to start thinking about the longer term.

Key points

- Money market is for the short-term
- Peaking rates suggest locking in yields for longer
- Falling rates will generate attractive capital gains

The attraction of money market investment

Very short-term, money-market-type investments, with or without credit risk, represent an important asset class. They allow investors to park cash until a more attractive investment is found or simply to ride out a storm, such as the one they have been facing since early last year, with minimal capital at risk. In times of rising rates, there is the additional satisfaction of rolling a maturing investment into a higher-yielding one with each maturity. Given their short-term nature, investors can even accept increased concentration risks on T-bills, supposedly risk-free, or bank placements, where higher minimum investments and temporary lock-ups are required to access the juiciest rates.

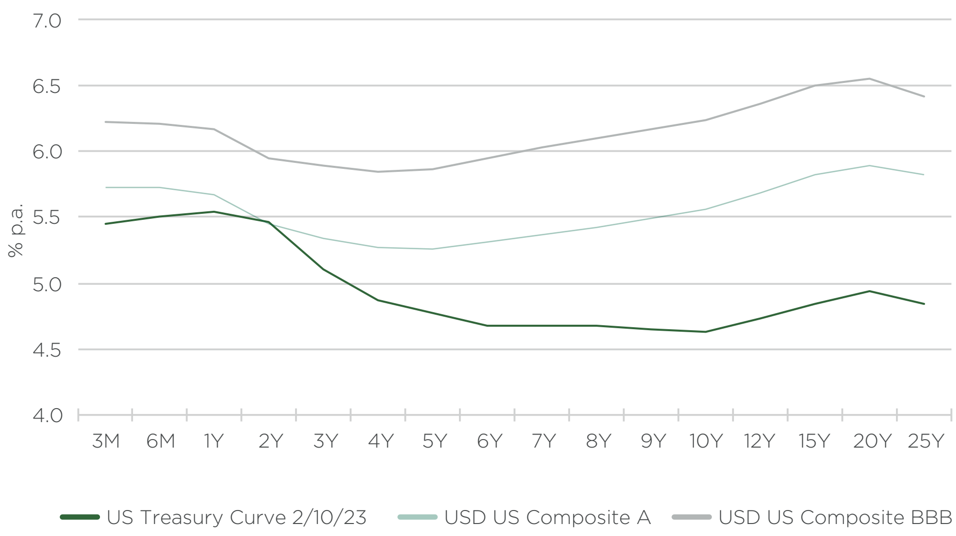
Interest rates are not stable

Rates have been rising for more than eighteen months and may increase further. But inverted yield curves, such as the current one in the USD space, tend not to persist for too long. Eventually something will give and the entire rate structure will reset. Since market timing is often an elusive quest, investors fully allocated to money market investments will struggle to catch the rate train going into reverse. Only T-bills allow a swift and virtually cost-free exit. As we are approaching the peak in short-term rates, investors need to prepare to switch maturing money market placements into longer-dated fixed-income assets.

Locking in yields and more

Investors wishing to maintain a similar level of yield as currently on offer for money market investments will need to take some duration risk and possibly credit risk. At this stage of the cycle, credit risk should be limited to investment-grade-rated bonds and spread across multiple issuers and, in order to enhance long-term returns, staggered maturities. But investors should not only focus on safeguarding their current yield levels. As rates will eventually move lower, longer-dated fixed-income assets will also benefit from their repricing to lower rate levels. This will translate into capital gains, which can be substantial at times. Moreover, many seasoned bonds were issued with very low coupons and are now trading at large discounts. This enables the same nominal exposure to be bought for less capital, and may also be tax-efficient, since many jurisdictions only tax income but not capital gains.

Yield curve will eventually steepen again



Source: Bloomberg, HBZ

MARKET SUMMARY DATA

As of 2 October 2023

Equity indices	Last	-3M %	YTD %	-3Y %
BBG World USD	1,528.9	-3.4	10.0	24.5
S&P 500	4,288.1	-3.6	11.7	28.1
EuroStoxx 50	4,169.6	-5.2	9.9	30.7
FTSE 100	7,590.9	0.8	1.9	28.6
SMI	10,880.4	-3.5	1.4	6.1
Nikkei	31,759.9	-4.3	21.7	37.9
BBG EM USD	1,075.9	-2.4	1.4	-3.4
Sensex 30	65,828.4	1.7	8.2	70.1
KSE 100	46,643.1	12.9	15.4	13.2
Hang Seng	17,809.7	-5.9	-10.0	-24.1
Russia RTS	1,009.5	2.7	4.0	-12.1
Brazil Bovespa	116,565.2	-1.3	6.2	24.0

Bond indices	Last	-3M %	YTD %	-3Y %
FTSE US Gov	1,450.78	-2.9	-1.2	-15.9
FTSE US Corp	2,249.76	-2.8	0.4	-13.7
FTSE US HY	1,174.43	0.7	6.2	6.0
FTSE Euro gov	204.14	-2.3	0.0	-20.4
FTSE Euro Corp	224.77	0.3	2.6	-11.1
FTSE EM Sov	772.28	-3.0	1.0	-15.0
DB EM Local USD	154.09	-3.0	7.4	-8.7

Currencies vs. USD	Last	-3M %	YTD %	-3Y %
DXY	106.17	3.4	2.8	13.4
EUR	1.06	-3.4	-1.5	-10.0
CHF	0.92	-1.7	1.4	0.9
GBP	1.22	-4.1	0.8	-5.9
JPY	149.37	-3.3	-12.4	-29.7
AUD	0.64	-4.1	-6.0	-10.6
CAD	1.36	-2.6	-0.4	-2.2
ZAR	18.92	-1.5	-10.5	-13.2
INR	83.19	-1.2	-0.4	-11.1
PKR	287.74	-0.2	-21.1	-42.7
Gold oz	1,848.63	-4.5	0.5	-3.5

Interest rates	3M interbank %	10Y government %
USD	5.66	4.62
EUR	3.95	2.87
GBP	5.41	4.49
CHF	1.71	1.13
JPY	0.02	0.78
AUD	4.14	4.49
CAD	5.51	4.03
ZAR	8.33	12.44

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FOR YOUR NOTES

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